Massachusetts Electric
A National Grid Company

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Counsel

May 23, 2002

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: Petition of Massachusetts Electric Company and Nantucket Electric Company for Approval of its Rate Reconciliation and Adjustment Filing, D.T.E. 01-102

Dear Secretary Cottrell:

This letter responds to the letter of the Attorney General dated May 17, 2002 in the above matter. In that letter the Attorney General suggests that the Department require Massachusetts Electric Company and Nantucket Electric Company (together "Mass. Electric") to refund prior collections and defer prospective recovery in rates of uplift costs and related expenses that are currently in dispute under Mass. Electric's power supply contract with USGen New England, Inc. ("USGenNE").[1]

The facts are not in serious dispute. On August 5, 1997, Mass. Electric executed a contract with USGenNE for standard offer service in connection with the divestiture of its generating facilities. The contract was last amended in September 1, 1998 ("Standard Offer Service Contract"). Ex. AG-1-1. The Standard Offer Service Contract was filed with and analyzed by the Department as part of its approval of the divestiture in Docket D.P.U./D.T.E. 97-94, pp. 8-9, 26-29 (1999). Because the divestiture occurred early in the restructuring process in New England, many of the NEPOOL and ISO rules were not yet fully established. As those rules have developed, a dispute has arisen over which party to the contract is responsible for uplift costs and related expenses. USGenNE contends that Mass. Electric, as the distribution company, is responsible, and Mass. Electric contends that USGenNE is responsible as the supplier under the Standard Offer Service Contract. See AG-1-1 for a report. The matter is now under arbitration.

[1] An identical contract is in place with TransCanada, which also is disputing the charge. The resolution of the TransCanada dispute will, as a practical matter, be governed by the outcome of the USGenNE dispute. The TransCanada disputed amounts are included in the values cited in the record and in this letter. Tr. 5/3/02, pp. 12-13. In addition, TransCanada has recently demanded arbitration on a separate contractual matter. No costs have accrued to Mass. Electric to date for this contractual matter.

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The amount in dispute was $23 million as of September 30, 2001, and an additional $6.2 million of disputed charges were estimated for calendar year 2002, producing a total of about $30 million. (Ex. AG-1-1, Tr. 5/3/02, p. 6). Mass. Electric is paying the ISO the disputed charges until the matter is resolved, and has already collected $23 million in disputed payments from customers through the transmission adjustment in its retail rates. The additional $6.2 million of disputed charges projected for 2002 are included in Mass. Electric's current transmission rates, which are now in effect and will be collected through the balance of the year. In the event that Mass. Electric prevails in the arbitration, it will return any recoveries to customers through the same mechanism that the disputed charges have been collected.

The Attorney General objects to this approach. Rather, the Attorney General would require Mass. Electric to: (1) credit back to customers the $23 million of disputed payments that Mass. Electric has paid to the ISO and recovered from customers in prior years; and (2) defer collecting the $6.2 million of future payments to the ISO associated with the disputed charges. Under the Attorney General's proposal, Mass. Electric would recover the funds from customers only if Mass. Electric loses the arbitration. Although Mass. Electric has been recovering these funds from customers since 1999, this is the first year that the Attorney General has objected to this approach.

The Attorney General supports his proposal by suggesting that Mass. Electric's customers should not be required "to pay for costs and expenses that the Company has determined another party should bear," and that allowing "recovery of these costs on an on-going basis deprives MECO of any incentive to pursue its position vigorously." The Attorney General has it backwards. A Department policy that mandates deferrals of disputed charges will discourage utilities from litigating cases that are legitimately in dispute, and will create a disincentive for any utility "to pursue its position vigorously." Quite simply, Mass. Electric's decision to pursue its claim vigorously against USGenNE is already creating significant litigation costs, which are not being recovered from customers. Under the Attorney General's proposal, the vigorous pursuit of its position would also lead to a substantial shortfall in the recovery of current cash outlays.[2] The incentive under the Attorney General's proposal is the opposite of what he seeks. The utility does not have the incentive to pursue its position "vigorously"; it does have the incentive to settle as quickly as possible so that the utility can maintain cash flow and limit litigation costs. Litigation and settlement is always a balance of costs and risk. The point here is that the Attorney General's approach shifts that balance away from the direction that he seeks; it creates a disincentive to the vigorous pursuit of the utility's position. As a result, it should be rejected as a matter of principle.

In this case, the suggestion should also be rejected on the facts. First, the charges themselves are imposed by the ISO under procedures that have been approved by the Federal Energy Regulatory Commission ("FERC"). See Ex. AG-1-1 for a discussion of the current proceedings at FERC on the uplift issue. The only question in the arbitration is which party should pay the costs, not whether the costs should be imposed.

[2] Mass. Electric notes that if the Department were to agree with the Attorney General's approach, Mass. Electric should be allowed to accrue interest on this and any future deferred amounts.

Second, the underlying Standard Offer Service Contract between Mass. Electric and USGenNE is also reasonable. It, too, has been approved by FERC, 82 FERC Par. 61,179 (Feb. 25, 1998), and reviewed by the Department in Docket D.P.U./D.T.E. 97-94 (May 22, 1998). The Standard Offer Service Contract was a critical element in the restructuring of the electricity market in New England. It was designed to provide price stability and consistency that allowed retail choice to begin early in Massachusetts, before the rules for wholesale markets were fully developed. The underlying dispute with USGenNE flows from the early implementation of retail choice in Massachusetts. Mass. Electric opened its retail markets before the wholesale market rules were implemented. At the time that Mass. Electric negotiated the Standard Offer Service Contract, Mass. Electric believed that it had addressed all known and future cost allocations in the Standard Offer Service Contract. When the wholesale market rules were subsequently developed, however, this dispute arose. Disputes of this kind are almost unavoidable, given that new wholesale market rules have been continually issued to complete the transition from regulated utility supply to market driven commodity pricing. These new rules were not available at the time the Standard Offer Service Contract was signed and their subsequent implementation will naturally lead to disputes about the responsibility for payment.

Finally, the Attorney General's proposal to refund $23 million and defer recovery of an additional $6.2 million are not necessary to produce price stability for Mass. Electric's customers. The prices for standard offer service continue to be below the market. Current standard offer charges to Mass. Electric's residential customers are 5.6 cents per kilowatthour, well below current default service prices of 6.9 cents per kilowatthour for residential customers. The surcharges produced by the high fuel prices that occurred over the past two years are being eliminated from the standard offer service rates, and as a result standard offer charges are likely to drop to 4.2 cents per kilowatthour on July 1, 2002. Mass. Electric's total charges, including the standard offer charge, are also well within the fifteen percent reduction required by the restructuring statute. Now is not the time to drive prices down through a forced deferral and refund, only to see them increase markedly if the arbitration produces an adverse outcome.

For all these reasons, the Department should reject the Attorney General's proposal that would require Mass. Electric to refund $23 million of disputed uplift and related costs and to defer an additional $6.2 million of these charges prospectively, and continue to approve the collection of these charges as they are incurred, subject to refund, and with a continuing reconciliation with customers.

Very truly yours,

Amy G. Rabinowitz

cc: Wilner Borgella